How To Get Out of Debt

Credit cards and loans provide an easy and convenient way to buy the things you need now and pay for them later. Surviving today without a credit card is almost impossible. Credit cards allow you to reserve hotel rooms and rental cars and are a safer way to order goods online or through the mail. The downside is that the ready availability of credit may make it easier to borrow more than you can afford to repay in a reasonable amount of time. Too much debt can mean most of your income goes for debt payments instead of for current purchases and saving for future needs.

There are good and bad uses for credit. A good use is convenience—meaning you pay the balance off in full every month to avoid finance charges. Another good use is to finance an asset, such as a college education, a home, or durable goods like furniture or appliances. When you use credit make sure it is for a good reason. Used wisely, credit is a valuable tool to help you reach important goals.

Using a major credit card (i.e., Visa, Mastercard, or Discover) to buy big-ticket items may provide additional protections. If you have a problem with your purchase of more than $50 from a retailer in your home state or within 100 miles of your home, paying with a credit card allows you to dispute the charge and withhold payment until the problem is resolved. However, using a credit card rather than an installment loan for a major purchase often means a longer repayment period and higher finance charges.

Many people find that the more they use credit, the more they need to use credit to make ends meet. Fall behind on payments and credit becomes even more of a problem as additional finance charges and late fees accumulate. On top of the additional fees you may see your interest rates and payments go up and your credit score go down. Paying only the minimum payment printed on the credit card statement will mean staying in debt for a long, long time. The longer it takes you to repay a debt, the more you will have to pay in interest.

For example, if you owe $1,000 on a credit card with an annual percentage rate (APR) of 18%, how long will it take you to pay off the credit card? Paying only the required 2% minimum payment means taking 19 years and 4 months to pay off the balance, including an additional $1,931 in interest. Sticking with the $20 per month payment required with a $1,000 balance means making payments for 7 years and 2 months to pay off the balance along with more than $860 in interest. Increase your payment to $50 per month speeds up the time to pay off the debt to just 2 years and costs less than $200 in interest.

Many creditors want you to make only the minimum payment because it generates a lot more interest income for them. When a creditor allows you to skip a payment because you paid more than the minimum with your last payment or as a special gift around the holidays, they are not doing you any favors because interest still accumulates on the unpaid balance. Paying off credit card debt as fast as you can saves you money.

Getting out of debt has other benefits as well. Being debt-free makes you more financially secure, allowing you to focus more on your financial future. It also creates flexibility because the money once used to make debt payments is now available for other purposes. Reducing or eliminating your debt may also improve your credit score, making it cheaper to borrow money in the future. Paying off your debts is a wise investment that will reward you for years to come.

Types of Credit

Credit is not all the same. There are many ways to categorize credit. The most important considerations focus on the repayment terms (installment credit versus revolving credit) and whether or not there is collateral associated with the debt (secured credit versus unsecured credit).

Installment credit is usually associated with the purchase of an item, such as furniture or an automobile. You make a monthly payment for a specific period of time until the balance is paid off. You cannot add new charges so the amount you owe goes down with each payment. You can easily determine the total amount you will repay by multiplying the number of payments times the payment amount. Subtract the cost of the item from the total to determine how much you will pay in interest.

With revolving credit you pay a percentage of the balance each month. As long as you make at least the required minimum payment every month and have not exceeded your credit limit, you can continue to add to the balance. The interest rate may go up or down depending on how you repay the debt and other factors.

Secured debt is tied to some form of collateral. With installment loans the collateral is the item you purchased with credit, such as a home, vehicle, furniture, or appliance. If you do not make payments, the creditor will repossess the collateral for the loan. If the debt was secured by a cosigner, the creditor will contact the cosigner to request payment. If you decide to file for bankruptcy, secured debts receive higher priority than unsecured debts.

With unsecured debts like there is no collateral. Examples include medical bills, most credit cards (unless a deposit equal to the credit limit was required to open the account), and money you owe to family members or friends. If you file for bankruptcy, because they are a lower priority than your secured creditors, unsecured creditors may get nothing. Consequently, unsecured creditors are usually willing to work with you when you run into trouble paying your bills.

Unsecured creditors are often the first to call when you miss a payment. Repaying them should be a lower priority than repaying your secured creditors. Keep in mind that missing a payment to any creditor has a negative impact on your credit score and will likely lead to late fees and additional finance charges.

Assessing Your Situation

Once you make the decision to get out of debt, the first step is to assess your situation. If you have trouble making at least the minimum payment on your debts each month, seek the help of a professional credit counselor. Legitimate credit counseling organizations have agreements with creditors that may mean a significant reduction in the total amount you will need to repay. In most cases you will be required to cut up your credit cards and to make payments to your creditors via the credit counselor for three to five years.

Another option is to consolidate your debts so you make one payment that is usually lower than the monthly amount you currently pay to your creditors. Debt consolidation is rarely a good idea. The interest rate is often higher. The lower payment also means you will likely need to make payments for a longer period of time, further increasing the amount you owe. If debt is your problem, borrowing is rarely the answer.

You may also use a home equity loan or line of credit to pay off all your debt. Using your home equity may mean a lower interest rate and in many cases, allows you to deduct the interest on your tax return. A home equity loan will almost always extend the time it will take to get out of debt which may be enough to offset any savings from a lower interest rate. Paying off your credit cards with a home equity loan also means you switch unsecured debt to a secured debt. If you are unable to repay the loan you could lose your home.

Because debt consolidation is a bad choice and tapping into your home equity places your home at risk, your best bet is to develop a repayment plan on your own. If you can afford to make at least the minimum payment each month, you can get out of debt. It is worth your time to contact your creditors to ask for a reduction in the interest rate. You may be surprised by how willing your creditors may be to work with you, especially if you have a good repayment history with them. The worst that could happen is that they will say no.

Make Power Payments to Get Out of Debt Fast

Commit to paying the same amount each month toward getting out of debt. For example, if you have five credit cards and pay each creditor $50 per month, continue to pay a total of $250 every month until you are out of debt. Instead of paying a little extra on each credit card, make only the minimum payment on all your credit cards but one and apply every extra penny you can find to one "power" payment to the last credit card. You will save more in finance charges if you apply the power payment to the debt with the highest interest rate. Sometimes it is worth selecting the loan with the lowest balance or shortest term for the power payment so you quickly get satisfaction from eliminating one of your debts.

Once you pay off the first debt, add the payment you were making to that creditor to the payment for the debt with the next highest interest rate. Turbo-charge your debt repayment plan by coming up with additional dollars to add to your power payment. The larger your payment, the faster that debt will be paid and the less interest you will pay. Consider applying a portion of your tax refund, annual bonus, gifts you receive, or other windfalls to your power payment for even greater savings.

Getting out of debt is one of the smartest investments you can make. Once you are debt-free you will have the amount of your regular debt payments to use for other things. Since you are already used to doing without the money, consider saving all or part of it every month. Set a goal to save three- to six-months of living expenses for emergencies. When you have reached that goal you can use the money for other important goals such as a child's education or for retirement.

Michael Rupured, M.S., AFC
Former Senior Public Service Associate and
Extension Consumer Economics Specialist

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